Euro wrap-up

Overview

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- Bunds made gains as the ZEW survey suggested that investor expectations of German business conditions have improved to a nine-month high on expectations of cooling inflation and lower rates.
- Gilts outperformed as UK pay growth moderated while payrolls fell slightly and jobless claims rose again.
- Wednesday will bring October data for euro area industrial production and UK GDP.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.703	+0.004
OBL 2.4 10/28	2.206	-0.022
DBR 2.6 08/33	2.219	-0.048
UKT 3½ 10/25	4.502	-0.105
UKT 4½ 06/28	4.035	-0.108
UKT 3¼ 01/33	3.949	-0.127

*Change from close as at 4:00pm GMT.
Source: Bloomberg

Euro area

German investors more upbeat about outlook as expectations of rate cuts rise

Ahead of Friday's flash December PMIs, today's German ZEW investor survey findings were broadly consistent with progress towards a stabilization in economic conditions in the euro area's largest member state this quarter. In particular, the survey's current assessment balance rose for the second successive month in December, by 2.7pts to a four-month high of -77.1. Admittedly, the improvement was smaller than had been expected by the Bloomberg survey consensus, and for a second successive month no survey respondent judged conditions to be 'good'. Moreover, despite the recent improvement, the average index for the fourth quarter as a whole was some 9pts below the Q3 average, and well below the average in the five years before the pandemic (+54.2), tallying with perceptions that Germany's economy remains fragile and likely slipped into mild technical recession in the second half of this year. Nevertheless, the recovery in investors' expectations for the coming six months – up for a fifth consecutive month to a nine-month high of 12.8 – was more encouraging, supporting our view that the bottom in Germany's downturn has been reached in Q4. The survey detail suggests that the investor mood has been boosted by moderating inflation and the prospect of looser monetary policy. Indeed, while the share of respondents expecting inflation to rise over the coming six months rose to its highest in more than a year (9%), roughly two-thirds continued to expect it to decline. And the share expecting short-term interest rates to fall in the next six months more than doubled in December to 47%. Against this backdrop, there was diminished optimism with respect to bank profits over the coming six months, offsetting less pessimism among construction, services and retail firms.

The day ahead in the euro area

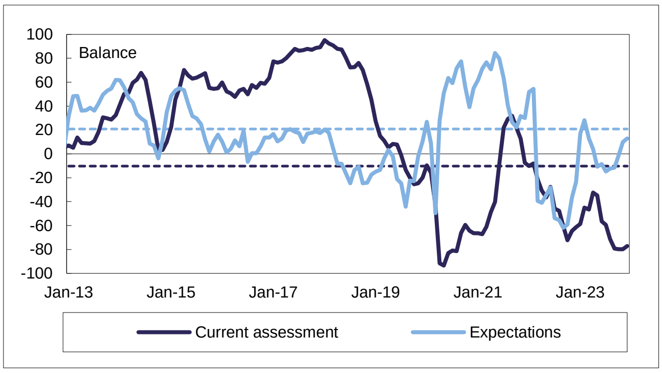
Ahead of Thursday's ECB announcements, tomorrow will provide a further update on the euro area's manufacturing performance at the start of Q4, with data for industrial production in October. Figures published so far by the member states – including very modest declines in Germany, France and Italy and a more substantial drop in Ireland (-7.0%M/M) – suggest that euro area IP fell about ½%M/M in October, which would mark the third monthly drop out of the past four.

UK

Wage growth moderating as inflation eases

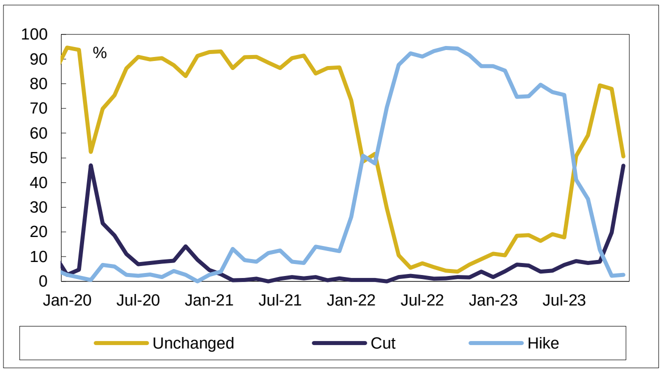
With inflation slowing, pay growth – currently one of the three key variables in the BoE's policy reaction function – continues to moderate too, adding to evidence that the labour market as a whole is becoming steadily less tight. Growth in total average weekly earnings in October of 7.2%3M/Y was still highly elevated by historical standards. But that was 1.5ppts

Germany: ZEW investor sentiment indices*



**Dashed lines represent long-run average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

Germany: ZEW expectations for interest rates



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

down from the peak in July and 0.5ppt below the median forecast on the Bloomberg survey. Stripping out the influence of bonuses, regular pay growth similarly slowed ahead of expectations in October to 7.3%3M/Y, 0.6ppt below the summer peak, with regular private sector pay easing to the same rate. Most importantly, those figures are exaggerated by the extremely sharp pay rises in the spring, when workers were seemingly more determined and better able to extract compensation for the high inflation of the past couple of years. And on a three-month basis, pay growth has recently slowed significantly. Excluding bonuses, regular pay growth moderated in October to 4.4%3M/3M annualised, down more than 5ppts from the peak in June. And private sector regular pay growth eased 1.8ppts in October to 4.0%3M/3M annualised, 6.5ppts below the peak, with a moderation in all major sectors. Moreover, on the (admittedly volatile) single-month basis, nominal private sector pay actually fell in October, suggestive of continued weakening of momentum heading towards year-end. Indeed, if anything, the BoE's projections for private sector regular pay growth of 7.2%3M/Y at year-end and 6.5%3M/Y next March are now looking on the high side.

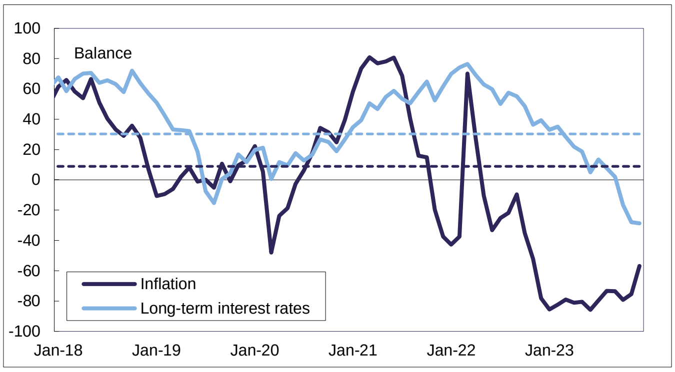
Most evidence points to gradual loosening of labour market conditions

Alternative measures of labour earnings provide a similar story to the ONS figures. For example, the rate of growth of median pay using HMRC data slowed 0.9ppt in November to 5.3%Y/Y, 4.3ppts below the June peak, and to just 0.8%3M/3M annualised. And, last week, the REC survey measure of permanent staff starting salaries fell for a seventh successive month in November to the lowest level since March 2021, well below the average in the five years before the pandemic. Those indicators suggest that another of the BoE's current key variables in its policy reaction function, the underlying tightness of the labour market, is gradually easing too. Indeed, the number of job vacancies in the economy fell for a seventeenth successive month in the three months to November, dropping 45k on the quarter to 949k. In addition, the number of payroll employees – admittedly a figure that is typically revised after the initial estimate – edged down 13k last month. And jobless claims rose in November for the third successive month, and for the seventh month out of the past nine, albeit leaving the claimant count rate unchanged at 4.0%.

ONS alternative measure suggests unemployment broadly stable below BoE NAIRU estimate

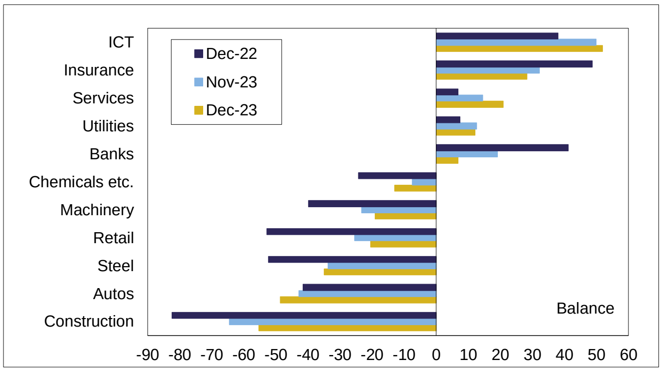
As the official Labour Force Survey indicators are currently suspended due to the low survey response rate, however, the BoE will be unsure about the precise extent of underlying tightness of the labour market. Indeed, the ONS's new alternative measures, informed by the payrolls and jobless claims data, suggest that the employment (75.7% for those aged 16-64 years) and unemployment rates (4.2% for those aged 16 and over) were broadly unchanged in the three months to October. As such, while it was up 0.5ppt from a year earlier, the alternative estimate of the unemployment rate was still below the

Germany: ZEW inflation & 10Y Bund expectations*



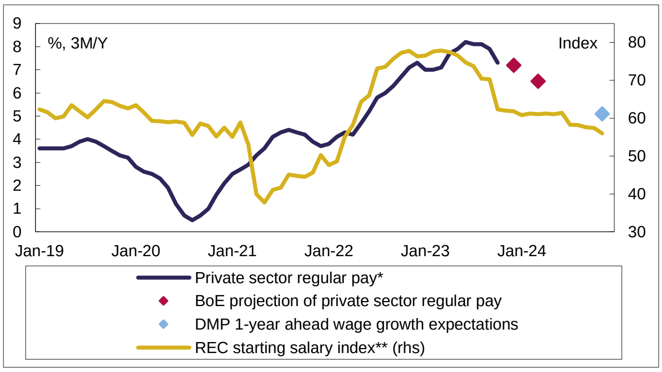
*Dashed lines represent long-run average. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: ZEW survey profit expectations



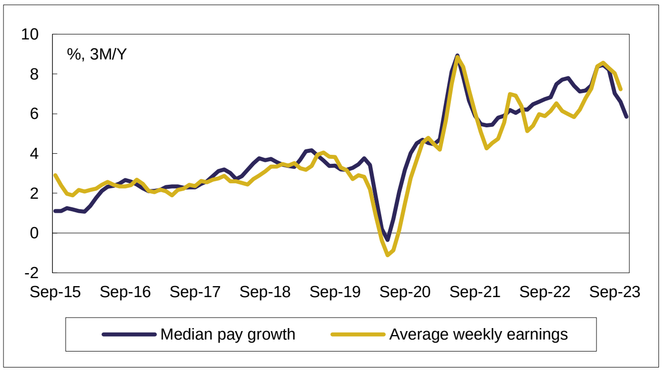
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Wage growth measures



*Data between January 2020 and November 2022 is BoE staff estimate of underlying private sector regular pay growth. **REC index has 12-month lead. Source: Macrobond, BoE, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Average weekly earnings & median pay growth



Source: Macrobond, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

BoE's new estimate of the medium-term equilibrium rate or NAIRU (4½%), which was revised up last month due to evidence of less efficiency in job matching. The BoE will also be mindful that the aforementioned measure of payrolled employees, as well as a survey measure of workforce jobs, which rose 210k on the quarter to a new series high in September, remain well above their levels just before the pandemic. It will also note that, thanks to lower inflation, pay is rising again in real terms – deflated by the ONS's preferred CPIH measure, real regular pay in October was up 1.4%3M/Y, 4.1ppts stronger than the same period last year. Looking ahead, the cut in National Insurance Contributions will further increase take-home from January. And the National Living Wage will rise by 9.8% in April for workers aged 21 and over, and at a faster rate than that for younger workers, to provide a further (probably modest) positive impulse to pay at the low end of the scale early next year. Moreover, thanks to the recent drop in swap rates, the associated easing in mortgage rates suggests that the disposable incomes of re-mortgaging households will not be squeezed quite so much over coming quarters too.

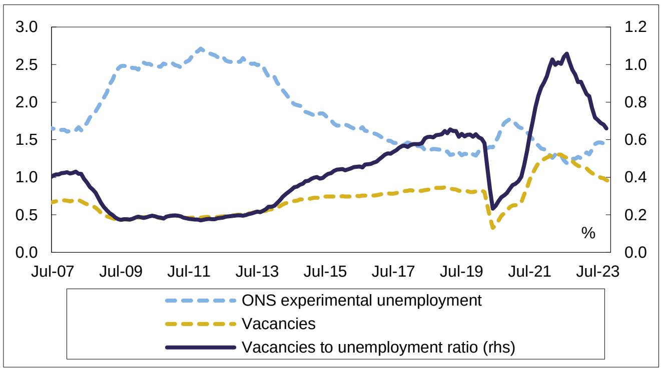
MPC to maintain tightening bias on slightly improved economic outlook

So, at this week's monetary policy meeting, the MPC will probably judge that the near-term economic growth outlook has improved somewhat since updating its macroeconomic projections just last month. So, it might also judge that the unemployment rate will not rise over coming quarters quite as far as it previously expected (i.e. to 4.7% by end-2024 and to 5.0% by end-2025). It will consider private regular pay growth on the three-month annualised basis to remain above rates that might be considered consistent with the achievement of the inflation target over the medium term, and will not take for granted its continued moderation over coming quarters. And despite the downside surprise in the October data, it will not need reminding that services, core and headline inflation, all remain elevated by historical standards and higher than in any other G7 economy. So, despite today's evidence of softening pay momentum, it will remain mindful of persisting upside risks to the inflation outlook. And consistent with recent comments by most members of the Committee, including BoE Governor Bailey, we expect the MPC on Thursday to insist that policy will need to remain restrictive for an extended period of time, and indeed maintain its tightening bias. So, it will appear to push against the swaps market, which is now fully pricing a first rate cut next June and two or three further cuts before the end of the year. Like the market, we expect the first cut to come next summer, albeit not until August.

The day ahead in the UK

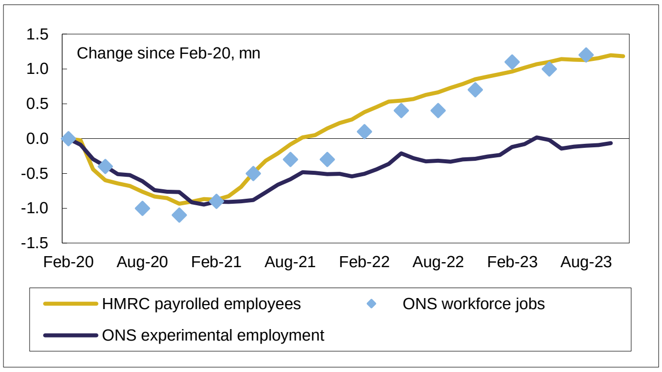
Ahead of the BoE's policy announcement on Thursday, tomorrow will bring the monthly GDP data for October. Despite a further decline in retail sales at the start of Q4, and sluggish activity in the manufacturing and construction sectors, we think GDP might report a third successive very modest monthly increase in growth (0.1%M/M), supported by stronger growth in the healthcare sector. Figures in line with our expectation should suggest that a contraction in UK GDP should just about be avoided in Q4.

UK: Vacancies & unemployment



Source: ONS, Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Measures of employment



Source: Bloomberg, ONS and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany		ZEW current assessment (expectations) balance	Dec	**-77.1 (12.8)**	-75.5 (8.8)	-79.8 (9.8)	-
UK		Payrolled employees, monthly change '000s	Nov	**-13**	-	33	39
		Unemployment claimant count rate % (change '000s)	Nov	**4.0 (16.0)**	-	4.0 (17.8)	- (8.9)
		Average weekly earnings (excluding bonuses) 3M/Y%	Oct	**7.2 (7.3)**	7.6 (7.4)	7.9 (7.7)	8.0 (7.8)

Auctions

Country		Auction
UK		sold £3.75bn of 4.5% 2028 bonds at an average yield of 4.041%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
UK		Rightmove house price index M/M% (Y/Y%)	Dec	**-1.9 (-1.1)**		-1.7 (-1.3)	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		10.00	Industrial production M/M% (Y/Y%)	Oct	*-0.5 (-4.7)*	-1.1 (-6.9)
UK		07.00	GDP M/M% (3M/3M/)	Oct	*0.1 (0.2)*	0.2 (0.3)
		07.00	Industrial production M/M% (Y/Y%)	Oct	-0.1 (1.1)	0.0 (1.5)
		07.00	Manufacturing production M/M% (Y/Y%)	Oct	0.0 (1.9)	0.1 (3.0)
		07.00	Index of services M/M% (3M/3M%)	Oct	-0.1 (0.2)	0.2 (-0.1)
		07.00	Construction output M/M% (Y/Y%)	Oct	-0.2 (1.4)	0.4 (2.8)
		07.00	Trade (goods) balance £bn	Oct	- (-14.1)	-1.6 (-14.3)

Auctions and events

Country		GMT	Auction
Italy		10.00	Auction: €3.0bn of 3.85% 2026 bonds
		10.00	Auction: €3.0bn of 4.00% 2030 bonds
UK		10.00	Auction: £2.0bn of 3.75% 2053 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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